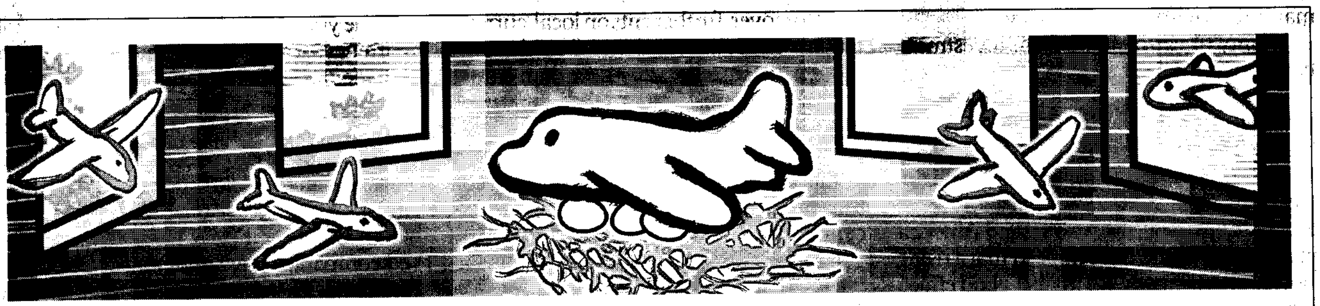

The never-ending question

Few economists doubt that freer trade helps economies grow faster. Yet the evidence on the link between trade and growth is under attack

ECONOMICS FOCUS

IT IS an article of faith for most economists that free trade boosts growth. With good reason: trade allows countries to import others' technology, and foreign competition spurs domestic companies to become more productive. For good measure, study after study has found a positive correlation between freer trade and growth.

The most influential paper in recent years was written by Jeffrey Sachs and Andrew Warner of Harvard University. The IMF, the World Bank, the OECD and other institutions often cite it in support of their advice to developing countries to liberalise their economies. The study found that developing countries with open economies grew by 4.5% a year in the 1970s and 1980s, but those with closed economies grew by only 0.7% a year. Rich open economies grew by 2.3% a year, closed ones by 0.7%.

Though economists had some theoretical quibbles—they always do—the issue looked settled. But Dani Rodrik, another Harvard economist, has thrown a cat among the pigeons. In a new study with Francisco Rodríguez of the University of Maryland, he challenges the findings of the cross-country studies that purport to establish a link between freer trade and faster growth. He is particularly scathing about the Sachs and Warner paper.

There are many difficulties in assessing the effect of trade on growth. One is that protected economies often have much else wrong with them as well, such as bad macroeconomic policies. So it is hard to tell if they are performing badly because they are protected, or for some other reason. Nor is it straightforward to measure how open to trade an economy is. For example, communist Poland had low import tariffs in the 1980s. Yet it was not an open economy: the government kept out imports by rationing foreign-exchange licences instead.

Messrs Sachs and Warner tried to overcome this problem in a novel way. They devised an openness indicator that takes account of the different ways that governments shut out imports. They classified economies as closed if they displayed any of five features: high import tariffs, high non-tariff barriers, a socialist economic system, a state monopoly on important exports, or a big gap between official and black-market exchange rates. By definition, their openness indicator is partly subjective. But it does not seem unreasonable; and their results appeared robust in a wide range of statistical tests.

Mr Rodrik disagrees. He thinks the openness indicator is a bad measure of trade policy, so its correlation with faster growth is spurious. Using fancy econometrics, he claims that most of the correlation between openness and growth can be explained by only two of the five criteria: the state monopoly on important exports and the black-market exchange-rate gap. He is not convinced that either is of much use. All the economies that Messrs Sachs and Warner consider closed because of a state export monopoly are in Africa and under World Bank care; their low growth may mostly be due to other factors. As for the black-market gap (which measures foreign-currency rationing), it may also reflect poor macroeconomic policy and be associated with corruption that could be the real dampener on growth.

These are potent criticisms. To Mr Rodrik they suggest "scepticism" about the merits of free trade. He seems to believe in a rehashed version of the age-old infant-industry argument: that temporary protection can boost growth by encouraging specialisation in sectors that become competitive over time through "learning by doing". He stops short of advocating protectionism, but his study will doubtless be used to that end.

Yet free-traders need not worry too much. For one thing, Mr Rodrik has not challenged the core of the pro-free-trade evidence. Export growth and overall GDP growth in developing countries are still strikingly correlated. As Mr Sachs points out, the first almost certainly causes the second. Developing countries need to export so as to get their hands on foreign currency. That enables them to import technology and capital goods that are only produced abroad. So growth is likely to be impeded by any measure that in effect taxes exporters, particularly tariffs or quotas on imported capital goods, or a non-convertible currency.

There are answers to Mr Rodrik's specific charges too. Even if he is right that the state-monopoly indicator is flawed, it is not crucial to the argument, since most of the African economies would be classified as closed for other reasons. As for the black-market currency-gap, he is wrong to say that it reflects macroeconomic problems rather than protectionism. When a country has a flexible exchange rate, macroeconomic chaos does not drive a wedge between official and black-market exchange rates. That happens only when foreign exchange is rationed. Moreover, there are many countries (India, for example) that formally ration foreign exchange but do not suffer macroeconomic instability.

There is a broader point, however. Free-traders, be they Mr Sachs, IMF economists or lesser mortals, should not base their case for open markets too heavily on crude cross-country studies. They allow critics such as Mr Rodrik to pick holes in their econometrics—which, given measurement problems, is all too easy. A better case for free trade can be made from detailed studies of individual economies, which can more easily make statistical allowances for a host of other factors that affect growth. Almost all such studies show that free trade is indeed good for growth. There may be a simpler and more convincing way of making the same point: ask people in the many countries that have successfully opened their markets in the past 20 years whether or not life is better than before.

The paper by Sachs and Warner is "Economic Reform and the Process of Global Integration", *Brookings Papers on Economic Activity*, 1995. The study by Rodríguez and Rodrik is "Trade Policy and Economic Growth: A Sceptic's Guide to the Cross-National Evidence", NBER paper no. 7081, April 1999.